What Economic Factors Should be Considered for Tax Expenditures?

Joint Informational Hearing

Assembly Committee on Revenue and Taxation;
Assembly Committee on Jobs, Economic Development, and the Economy

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Outline

- Goals: Social vs. Economic
- Taxes and Economic Activity
- Tax Expenditure Questions
- Manufacturers Investment Credit Example

Social vs. Economic Goals

- Personal tax expenditures account for 75% of total expenditures
- Personal tax expenditures are more oriented towards social goals (equity, relief)
- Business tax expenditures are more likely to be geared towards stimulus or economic incentives
- Economic goals are more readily analyzed, although data is often more limited

Taxes And Economic Activity - I

- Different approaches taken by researchers:
  - Comparative studies of entire state economies
  - Simulation models of state economies
  - Accounting analysis of "hypothetical" firm
  - Case studies of specific industries
  - Surveys
- ...Yield different answers…

Taxes And Economic Activity - II

- Most studies look at entire economy and show small, but significant, effects of taxes
- Results vary widely but find that a 10% decline in business taxes leads to a
  - 1-2% increase in employment
  - 1-4% increase in manufacturing investment
  - 2% increase in plant startups
- Investment incentives have larger effects than changes to overall tax rates

Taxes And Economic Activity - III

- Taxes matter more when other key factors (wages, skilled labor, infrastructure) are similar
- Wage effects are roughly double that of taxes, and skill requirements are often more important than wages
- Worker-related tax policies (worker's comp, unemployment) are more important to labor-intensive businesses
- Manufacturing industries are more sensitive to taxes, partly due to more intense national & international competition

Basic Tax Expenditure Questions

- What is the main policy goal?
- What industries are being targeted?
- What will utilization rate be?
- What is the approximate cost?
- What behavioral changes can be expected (including unintentional effects)?

Industry-Specific Questions

- Overall condition of industry?
- Factor intensity (relative importance of: labor, capital, land, infrastructure, technology)?
- Export orientation? Degree of competition?
- Other tax & policy changes affecting industry?
- Phase of the business, product cycles?

Tax Expenditure Evaluation

- Evaluations must sort out:
  - Short-run vs. long-run responses
  - Direct vs. indirect economic impacts
  - Non-quantitative factors
- Must account for other influences on investment
- Selection of appropriate performance benchmark is critical

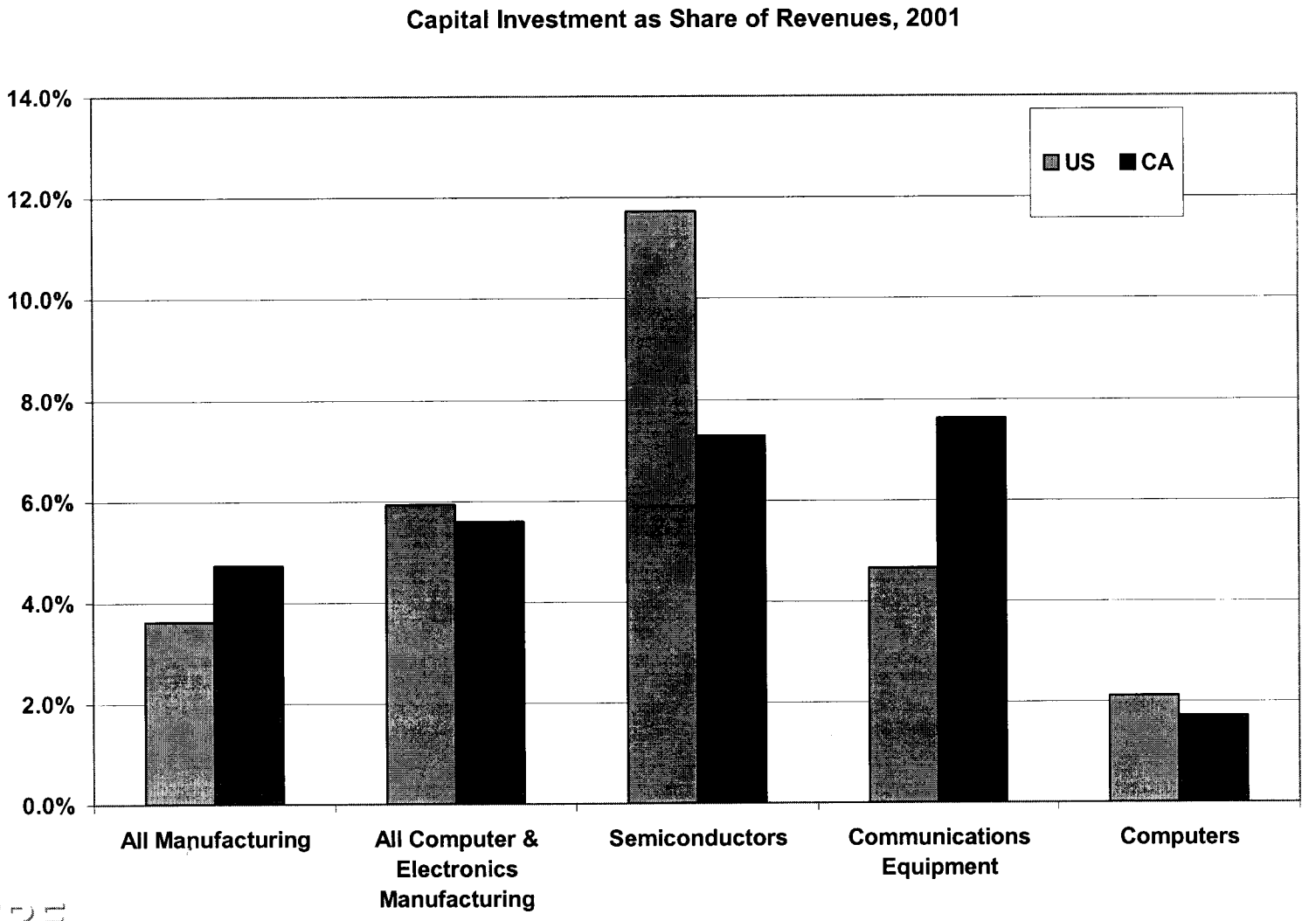
Example: Manufacturers Investment Credit

- Logic behind an investment tax credit:
  - Equipment investment is clearly important to the economy – recent boom and bust was due to surge, then collapse in business investment
  - Equipment investment is how technological innovation is diffused across economy
  - Technological innovation raises productivity
  - Productivity gains drive living standards

MIC In California

- Some basic facts:
  - $381 million in credits taken in 2001-02
  - 42% of credits were taken by IT industry
  - 18 states offer MICs
  - 30 states exempt manufacturing equipment from sales tax
  - DOF estimates that indirect effects offset ~30% of the MIC's revenue loss

California Has Higher Capital Intensity, Which Varies Across Industries And Time



Picking Performance Benchmark Is Important

- Benchmark for California's MIC was at least 100,000 new manufacturing jobs
- More accurate benchmarking would measure trends for only those firms taking the credit
- Need to account for existing level of investment without the MIC
- Even using existing benchmark, job increases in California manufacturing were 11% higher than in U.S. manufacturing from 1994-2002.

Evaluation Approaches For MIC

- Compare participating firms' investment before and after enactment of MIC
- Compare investment in plants taking MIC to similar plants elsewhere
- Simulate effects with input-output model (e.g., IMPLAN) or CGE model (e.g., DOF)
- Hypothetical firm comparisons

Potential Benefits From MIC

- Increased competitiveness for existing local plants compared to plants elsewhere
- Increased jobs, or fewer job losses
- More capital-intensive production could lead to higher-skill jobs
- Workers might acquire more competitive skills in plants with cutting-edge equipment

Benefits Must Balance Costs

- In 2001-02, $381 million in MIC claims
- $267 million net revenue loss after indirect effects are accounted for
- Likely increase of $160-240 million in equipment investment
- Economic benefits from increase in equipment investment must be balanced against other uses of tax revenues